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UNCLAS SECTION 01 OF 02 LILONGWE 000768

SIPDIS

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SUBJECT: MALAWI AT A CROSSROADS WITH IMF

REF: A. LILONGWE 719

[1](#)B. LILONGWE 728

SUMMARY

[1](#)1. (SBU) At last week's outbriefing to donor countries, the IMF's Article IV assessment team said Malawi's new government is going in the right economic direction and that the IMF team would recommend a Staff Monitoring Program for the 2004/05 fiscal year. They assessed the GOM's draft budget as realistic and workable, though tight, and expressed confidence that the GOM would succeed in establishing budgetary discipline. The new government is showing signs of the political will needed to achieve macroeconomic stability. If the new government succeeds in sticking to its budget over the next several months, donors will have to act quickly to avoid a balance of payments crisis late in the calendar year. END SUMMARY.

IMF ENCOURAGED, READY WITH MONITORING PROGRAM

[1](#)2. (U) At the end of a two-week Article IV assessment, a team from the International Monetary Fund (IMF) described themselves as "not at the end of a mission, but at the beginning of a new relationship." They said that the new government is going in the right direction, based on

- the team's review of June results, where targets were achieved "by a wide margin,"
- the draft budget for the July-June fiscal year just begun, and
- a review of achieved and proposed structural reforms.

The team characterized the budget as tight but workable, and perhaps most importantly, as inclusive of all foreseeable expenditures. Team leader John Green said the team saw good confidence in the economy, such that if the GOM sticks to its budget, economic conditions, particularly interest rates, should improve. Green said his team would recommend a 12-month Staff Monitoring Program, starting with July 2004, with reviews in September and December. The earliest recommendation for a new Poverty Relief and Growth Facility (PRGF) would be in December.

[1](#)3. (U) In addition to the sanguine assessment of financial indicators, the team took note of the new government's behavioral shift from the previous administration. The GOM has recently said no to extra funding requests, moved the President and Cabinet to Lilongwe to save travel costs, reduced the size of the Cabinet, and resolved to close five to seven embassies. (NOTE: The IMF team also mentioned the government's refusal to give Parliament a large pay increase, but unconfirmed media reports have since said GOM has agreed to an even larger pay package. END NOTE.) GOM officials have also said they are close to announcing a civil service wage reform package, designed to raise salaries, especially at the bottom of the scale, and reduce the numerous tax-free allowances for high-ranking civil servants. The team noted that its financial targets would allow for government grain purchases for this hunger season (late 2004 - early 2005) and for fertilizer subsidies for the 2004/5 growing season, provided the GOM can keep recurring costs within the new budget.

GONDWE: IT'S POSSIBLE, BUT NOT EASY

[1](#)4. (U) Responding to the IMF's briefing, Finance Minister Goodall Gondwe, a retired IMF official, said he welcomes the IMF's involvement as an opportunity for the GOM to get its financial house in order. He said he would be surprised if the needed reforms are not done in six months. That said,

Gondwe noted two factors working against GOM's fiscal reform: a possible food shortage late this year, and a need to build grain stocks in advance of a crisis, and a continuing need for fertilizer subsidies for the 65 percent of the population below the poverty line. He added to this an urgent need for civil service wage reforms. All of these will require relatively heavy government spending before the end of October and thus before donor assistance starts. In order to avoid another round of inflationary spending, he said, the Combined Approach to Budgetary Support (CABS) group of donors (which provide direct budgetary support) and the World Bank must release funds as early as possible.

COMMENT: SPENDING DISCIPLINE, THEN QUICK DONOR REACTION

15. (SBU) Whether Malawi falls into an inflationary spiral between now and the end of the calendar year depends on two things: the political will to reduce government spending, and the donors' ability to respond quickly should the GOM succeed. While it is still too early to judge the political will, the signs thus far are encouraging. The Mutharika government has shown signs of independence from the United Democratic Front (UDF) old guard (former president Muluzi's allies) in several ways, including its resistance to requests for off-budget funding, its replacing the director of public prosecution, a declared intent to prosecute former ministers for corruption, and a halt to privatizations pending investigation of financial irregularities. Mutharika's ability to change the GOM's spending behavior depends on his ability to garner support outside of established UDF/Muluzi circles, and in defiance of many entrenched political interests. Whether he can do so remains to be seen.

16. (SBU) If Mutharika succeeds in taming government profligacy, at least one hazard remains: the timing of foreign currency revenues at the end of the tobacco buying season. With the CABS donors and World Bank holding disbursements until the GOM has established its fiscal responsibility more firmly, a balance of payments crisis is a real possibility. These groups appear to want a clear signal from the IMF September review, a position we believe is prudent. This means that if the GOM performs well, donors will have to move quickly to avoid a devaluation of the currency at precisely the time that the economy is most susceptible to inflation. Mixed signals from the GOM on fiscal discipline or on the political stability needed to maintain that discipline will make a timely decision difficult.

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